consumers with the least choice -- those that are the least likely to see competition in the near term -- to continue to subsidize the business of their local monopoly telephone company.

Since competition generally takes root first in areas with the greatest concentration of traffic, those consumers that local competition has not yet reached will remain subject to the continuation of unwarranted excessive access charges while they wait for competition to develop. As indicated supra., while the 1996 Act recognizes that competition will have to come in many forms, this approach to access reform does not. The market-based approach disproportionately penalizes customers of certain entrants, which runs counter to the plain language of the Act and the Commission's previous position.[62]

For example, in places like California where MCI has some facilities but is, at least initially, providing local service as a reseller, excessive access charges will not be avoided. If the incumbent LECs are able to shift costs to the least competitive segments of the market, as would be the case under a market-based approach with significant pricing flexibility, it will do so and the development of local competition for all customers will be seriously impeded.

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[62] Local Competition Order at para. 12. ("The Act contemplates three paths of entry into the local market -- the construction of new networks, the use of unbundled elements of the incumbent's network, and resale. The 1996 Act requires us to implement rules that eliminate statutory and regulatory barriers to each. We anticipate that some new entrants will follow multiple paths of entry as market conditions and access to capital permit...Rather our obligation in this proceeding is to establish rules that will ensure that all pro-competitive entry strategies may be explored.")

This approach is not only unfair to those consumers without a facilities based alternative, but to new entrants as well. It allows the incumbent to continue to build up an anti-competitive war chest which can then be used in a variety of ways. Of greatest concern, the incumbent LEC can target the most lucrative customers by cross-subsidizing its long distance business once in-region entry is permitted, grabbing customers they would otherwise be unable to win.[63]

VI. Pricing Flexibility

As part of its "market-based approach" to access reform, the Commission proposes to afford the incumbent LECs additional pricing flexibility. This pricing flexibility would be granted in phases as the incumbent LEC demonstrated pre-defined, specific transition points or "competitive triggers." Phase I pricing flexibility would be permitted under conditions of "potential competition," while Phase II pricing flexibility would be permitted under conditions of "actual competition." The Commission justifies this additional pricing flexibility on the grounds that it would "permit LECs greater ability to price economically and

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[63] For instance, PACTEL, in an internal document, admitted that its cost of providing long distance service in-region are some 15 percent higher than AT&T's costs. This would indicate that PACTEL will have a great incentive to cross-subsidize its in-region long distance service or create mechanisms to artificially raise the costs of its competitors. California Public Utilities Commission Hearing Record from December 5, 1996.

therefore bring more competitive pressures, including lower prices, in areas and for services where we expect competitive forces initially to be the strongest."[64]

There is no evidence that the proposed grant of further pricing flexibility would have the effect of intensifying access competition and driving access to cost. In fact, it is more likely that the proposed pricing flexibility would enable the incumbent LECs to preempt the development of access competition. Premature pricing flexibility would permit the incumbent LEC to reduce access charges selectively in order deter new entrants, while continuing to charge above-cost access charges in areas and for services where there are no competitive forces. By slowing the development of competition, the pricing flexibility proposed by the Commission would only exacerbate the flaws inherent in the market-based approach.

A. Pricing Flexibility Should Not Be Granted Prematurely

As is outlined below, and discussed more thoroughly in the attached affidavit of Dr. John E. Kwoka, premature deregulation of monopoly incumbent LECs and a reliance on "market-based" pricing can lead to adverse effects on consumers and on efficient entry, to diminished market competition, and paradoxically, to the need for more -- not less-- regulatory oversight.

First, as Dr. Kwoka points out, while price cap regulation theoretically encourages cost efficiency and product innovation, results in "second-best"

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64 Notice at para. 168.

prices, blunts incentives for cross-subsidization, and is easy to administer, in actual practice nothing in price caps in any fashion alters the firm's incentives to maximize its private profitability at the expense of social objectives (e.g., cost minimization, product innovation, and cost-based pricing). Moreover, price cap regulation is not designed to foster competition, and in fact, allows for anticompetitive behavior by a dominant firm and actually can enhance its ability to deter entry and handicap rivals. With the decoupling of price from cost and with the unilateral ability to alter price, price-capped dominant firms have a greater ability to take actions that deter new entry.

Price caps may also result in a greater degree of unpredictability to prices, with potentially adverse effects on consumers and competitors alike. Since prices are no longer tied to costs or any other benchmark, the dominant firm may set and change prices for any reason it chooses (e.g., market perceptions, strategies, etc.). This unpredictability may be disruptive to consumers seeking nothing more than simple low-cost service and to competitors and new entrants striving to make rational investment decisions.

The ability of a price-capped firm to deter entry is nowhere more apparent than in the case where a monopoly firm supplies services needed by companies that are its competitors. Under price caps, the monopoly LEC has every incentive, and ability, to disadvantage rivals and undermine the evolution of competition by raising the price and/or lowering the quality of the necessary (bottleneck) service supplied to its rivals. As has previously been pointed out by the Commission, raising rivals' input costs or degrading input quality cripples those rivals and can force them out of the market. Nothing in the structure of price caps exists to thwart such actions.[65]

For these reasons, Dr. Kwoka concludes that the Notice's assertion that the market-based approach "creates incentives for incumbent LECs to act quickly to open up the local exchange and exchange access market to competition" (para 142) is based more on "hope than reality." The LECs have no incentive to promote competition --not inherently, not under price caps generally, and not as a result of the market-based approach proposed in the Notice. Granting the LECs enhanced pricing flexibility would allow them to distort the entry process. The proposed "market-based" approach would likely preserve continued market power for the LECs, require renewed regulatory oversight of various unresolved and contentious relationships between the LECs and its customers and competitors, and increase the difficulties prospective entrants into the access market will encounter.

Deregulation should be deemed appropriate only at the point that competitive forces can and predictably will constrain a firm with market power as well as regulation itself. The competitive forces must in actual fact be approximately equally constraining over such anticompetitive behavior as

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65 Even in markets where the dominant firm does not supply a direct competitor, the incumbent can mount a defense of its existing markets by selectively and strategically lowering price so as to render such entry unprofitable.

excessive prices that injure customers, strategic pricing and related conduct that inhibits competition, and undue discrimination. Unbundled network elements may in time represent an important competitive constraint, but the Notice places unwarranted reliance upon these untested devices.

B. Incumbent LECs Have Not Exhausted Existing Pricing Flexibility

Given the dangers inherent in premature pricing flexibility under price caps, the Commission should not grant additional pricing flexibility unless there has been a clear demonstration that existing pricing flexibility is inadequate to respond to the level of actual competition. The incumbent LECs, however, have generally failed to utilize their existing pricing flexibility. Even in the market for switched transport services, where there is nascent competition in some markets, the incumbent LECs have made little or no use of price cap rules that permit geographic deaveraging of transport rates and term and volume discounts.

In response to emerging competition, the Commission offered price cap LECs targeted and measured pricing flexibility which would increase in response to actual competitive conditions. In the expanded interconnection proceeding, price cap LECs were afforded the flexibility to price their switched trunking facilities differently in up to three zones, within existing service categories and subcategories.[66] The zone subcategories have upper pricing bands of 5 percent

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[66] Expanded Interconnection with Local Telephone Facilities, Transport Phase, Second Report and Order and Third Notice of Proposed

and lower bands of 10 percent. LECs are permitted to price below band with proper cost support, pricing their transport facilities at average variable cost. In a later order, price cap LECs were afforded the additional flexibility to offer volume and term discounts on switched transport.[67]

Density zone pricing, however, has not yet been implemented for access services in the areas serviced by RBOCs in 13 states[68] and by GTE in 13 states[69] even though such pricing flexibility is permitted. In many instance, even where density zone pricing has been implemented, pricing flexibility has not been used. For instance, Bell Atlantic has implemented density zone pricing structures throughout its region for certain services, however, rates are either the

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Rulemaking, CC Docket No. 91-141, 8 FCC Rcd 7374 (1993) (Switched Transport Expanded Interconnection Order).

67 Price cap LECs were permitted to introduce density zone pricing of interstate high-capacity transport once an expanded interconnection offering was operational in that study area, and were permitted to offer switched transport with volume and term discounts in any particular study area after one of the following conditions is met: (1) 100 DS 1-equivalent switched cross-connects are operational in Zone 1 offices in the study area; (2) an average of 25 DS-1-equivalent switched cross-connects per Zone 1 office are operational; (3) in study areas with no Zone 1 offices, the LECs may implement volume and term discounts once five DS-1 - equivalent switched cross-connects have been taken in the study area. Virtual Collocation Order, Expanded Interconnection with Local Telephone Company Facilities, CC Docket No. 91-141, Memorandum Opinion and Order, 9 FCC Rcd 5154 (1994) ("Virtual Collocation Order").

68 Alabama, Florida, Georgia, Kentucky, Louisiana, Maine, Mississippi, North Carolina, New Hampshire, Rhode Island, South Carolina, Tennessee, and Vermont.

69 Alabama, Arkansas, Indiana, Iowa, Kentucky, Mississippi, Missouri, Nevada, New Mexico, Ohio, South Carolina, Washington, and Wisconsin.

same in all zones or vary by a de minimis amount.[70] Similarly, SWBT has zone density pricing structure in place in Arkansas, Oklahoma, and Kansas, but the rates are identical in all zones.

Neither the RBOCs nor GTE are fully utilizing their ability to offer switched facility volume and term discounts to their access customers. For example, SWBT in some states has not implemented volume and term switched transport discounts even though they have met the Commission-designated threshold.[71]

As the table below illustrates, even though virtually all of the RBOCs continue to price their traffic sensitive, trunking, and carrier common line baskets as high as possible ("at cap"), the RBOCs have neither depleted nor extensively utilized the pricing flexibility already afforded to them within the specific service categories. Currently, all of the RBOCs have failed to utilize between 62 and 100 percent of their downward pricing flexibility in the local switching and voice grade service categories, and in the areas where incumbent LECs claim they face the most significant competition (zone 1 DS1 and DS3 transport), the

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70 For example, throughout the Bell Atlantic region less than 2 percent difference exists between zone 1 and zone 3 for entrance facilities.

71 SWBT in Texas, BellSouth in Georgia, Kentucky, and Tennessee, and GTE in North Carolina have not implemented volume and term switched discounts even though they had met the threshold. While there may be other instances where incumbent LECs have failed to institute volume and term discounts even though the cross-connect thresholds have been met, MCI has only been informed of these instance by the respective incumbent LECs.

RBOCs have still failed to used over 65 percent of their downward pricing flexibility in most instances.

Table VI-1: Unused Incumbent LEC Downward Pricing Flexibility[72]

	Local Switching	Voice Grade	DS1 (Zone 1)	DS3 (Zone 1)
Ameritech	71.5%	88.2%	28.7%	38.8%
Bell Atlantic	66.7%	77.7%	66.6%	66.8%
Bell South	62.3%	71.1%	64.5%	71.4%
NYNEX	66.3%	100.0%	93.8%	92.1%
Pacific Tel	64.3%	80.9%	71.7%	60.2%
SBC	66.1%	68.5%	49.3%	73.5%
US West[73]	79.2%	93.6%	83.1%	79.4%

The incumbent LECs have not yet taken advantage of the pricing flexibility that the Commission already permits, presumably because they currently face no significant competitive threat for access services. Therefore, no valid reason

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72 Information for Table VI-1 was compiled from USW Transmittal No 819, filed Jan. 15, 1997, Ameritech Transmittal No. 1042, filed December 30, 1996, NYNEX Transmittal No 443, filed December 31, Bell Atlantic Transmittal No. 931, filed December 31, 1996, BellSouth Transmittal No. 393, filed January 8, 1997, Southwestern Bell Telephone Transmittal No.2600, filed December 13, 1996, and Pacific Bell Transmittal No. 1900, filed November 27, 1996.

73 DS1 Zone 1 and Zone 3 reflect switched transport. US West has not utilized 80.5% and 79.8% of its downward pricing flexibility in its DS1 and DS3 Zone 1 Special Transport respectively.

exists for the Commission to grant, or even contemplate offering incumbent LECs more pricing flexibility.[74]

Moreover, evidence suggests that the RBOCs and GTE have not been harmed in the marketplace because of the current level of pricing flexibility afforded them. Examination of recent incumbent LEC actions, growth, and profitability clearly illustrate that their ability to retain current business, as well as secure new business, has not diminished. As is illustrated in table VI-2, in a year-over-year comparison, the incumbent LECs continue to increase local service and network access revenue significantly.

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74 Additional flexibility is even less appropriate at this time in light of the additional pricing flexibility afforded to the LECs in the Commission's Notice (e.g., removal of lower bands in price caps baskets), and the regulatory streamlining outlined in the Telecommunications Act of 1996 (e.g., tariff streamlining).

Table VI-2. **Revenue Growth[75]**
Percentage (%) Change
Year-Over-Year 3Q95 v 3Q96

	Network Access Revenue	**Local Service Revenue**
Ameritech	5.6	5.8
Bell Atlantic	3.3	5.2
Bell South	6.2	11.0
NYNEX	4.3	0.1
Pacific Tel	5.3	6.5
SBC	5.0	10.9
US West	2.3	9.3
GTE	8.0	4.2
Simple Average	5.0%	6.6%

Furthermore, access lines continue to grow at an increasing rate as several RBOCs set records for lines added during 3Q96. The main growth driver continues to be the strong demand for second access lines.[76] As depicted in table VI-3 below, access line growth (year over year) averaged 4.6 percent in 3Q96 for the RBOCs and GTE, matching 2Q96 for the highest growth in the last five quarters.

75 Revenue and access data, used to compute year-over-year revenue and access growth, were obtained from the Third Quarter 1995 and the Third Quarter 1996 Earning Releases for Ameritech, Bell Atlantic, BellSouth, NYNEX, PacTel, SBC, USWest and GTE.

76 See, footnote 9 supra.

Table VI-3. Access Line Growth[77]
Year over Year Growth

	Percent Change					Absolute Lines
	3Q95	4Q95	1Q96	2Q96	3Q96	3Q96
Ameritech	4.4	4.5	4.5	4.2	3.8	19.6m
Bell Atlantic	3.3	3.4	3.7	3.5	3.7	20.4m
Bell South	4.7	4.5	4.8	5.0	4.9	21.9m
NYNEX	3.0	3.4	3.6	3.8	3.9	17.6m
PacTel	2.7	3.2	3.9	4.7	4.4	16.3m
SBC	4.2	4.5	4.9	5.3	5.2	14.8m
USWest	3.5	3.6	4.2	4.2	4.0	15.3m
GTE	5.3	6.2	6.6	6.7	7.4	19.5m
Simple Average	3.9%	4.2%	4.5%	4.6%	4.6%	18.2m

Clearly, the RBOCs and GTE have not been harmed under the current price cap regime, and conditions do not exist which warrant increased pricing flexibility at this time. The Commission has never determined that interstate access services face significant competition, and has determined that, distinct from the rest of the country, only certain services offered by NYNEX in LATA 132 in Manhattan uniquely face "special circumstances," and therefore, warrant increased pricing flexibility.[78] No LECs have offered evidence that demonstrate

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77 Revenue and access data, used to compute year-over-year revenue and access growth, were obtained from the Third Quarter 1995 and the Third Quarter 1996 Earning Releases for Ameritech, Bell Atlantic, BellSouth, NYNEX, PacTel, SBC, USWest and GTE.

78 The NYNEX Telephone Companies Petition for Waiver, Transition Plan to Preserve Universal Service in a Competitive Environment, Memorandum Opinion and Order, 10 FCC Rcd 7445, released May 4, 1995. In determining whether to grant NYNEX a waiver so that it may implement its Universal Service Preservation Plan ("USPP"), the Commission explained that it granted this waiver because of the "special circumstances" that

that the "special circumstances" which warranted a waiver of the Commission's pricing rules in LATA 132 are present elsewhere.

The Commission has already set conditions, which when met, and when combined with the pricing flexibility already provided in price caps, allow the incumbent LECs substantial pricing flexibility. Until incumbent LECs demonstrate that they do not maintain monopoly control over essential bottleneck facilities, that they are significantly restrained or harmed by a lack of pricing flexibility, and that effective competition exists for access services, the Commission should not even contemplate extending increased pricing flexibility to the incumbent LECs.

C. Additional Pricing Flexibility is Without Justification and Would Slow the Development of Competition

Not only have the incumbent LECs failed to use their existing pricing flexibility under current competitive conditions, but there is no indication that existing pricing flexibility would be inadequate under the "potential competition" conditions described in the Notice. The Notice generally fails to enumerate specific restraints that current price cap rules place on the LECs' ability to reduce their access charges to cost or to respond to new entrants under conditions of potential competition. As discussed in the attached affidavit, the two-phase approach to granting additional pricing flexibility lacks a coherent theory relating the competitive triggers to the specific regulatory relief proposed.[79]

NYNEX faces in that area.

[79] Kwoka Affidavit at 20.

At the same time, there is every indication that incumbent LECs could use the proposed pricing flexibility in an anticompetitive fashion. The Phase I proposals would permit the incumbent LECs to lower access prices selectively. They could offer discounted rates only to important customers, or in areas where there was competitive entry, while continuing to charge above-cost rates in other areas. Thus, instead of increasing competition and thereby driving down access charges, the pricing flexibility proposed by the Commission would slow the development of competition and leave above-cost rates largely untouched.

On balance, then, the proposed pricing flexibility does not make the market-based approach to access reform any more viable. The two-phase scheme does nothing to encourage the competitive entry that might put downward pressure on LEC access rates. Rather, it would allow the incumbent LECs to preempt competitive entry. Moreover, the dangers inherent in the Phase I pricing flexibility proposals are exacerbated by the potential for BOC entry into the in-region interLATA market. In particular, the Commission's proposal to deregulate new service offerings and to permit contract tariffs would create an opportunity for the incumbent LEC to tailor access offerings for its interLATA affiliate.

1. Geographic Deaveraging

In the Notice, the Commission suggests that, where unbundled network elements are deaveraged, continuing to require access rates to be averaged across a study area would foreclose the incumbent LEC from meeting competition from unbundled network elements in low-cost areas. However, there is no indication that geographic deaveraging under conditions of potential competition under the market-based approach would accelerate the movement of access charges to cost. The essential problem with geographic deaveraging is that it would allow an incumbent LEC to lower access charges in only those markets where it faced competitive entry.[80] This would handicap entrants and rivals there, without jeopardizing LEC profit elsewhere -- and may even induce the LECs to raise charges in other markets.[81]

Further, there is no cost basis for geographic deaveraging of switching rates. No negotiation or arbitration conducted under Section 252 of the Act has yet resulted in geographically deaveraged local switching or tandem switching rates. Therefore, geographic deaveraging of switched access charges is not required for incumbent LECs to be able to respond to new entrants providing access using unbundled network elements. Deaveraging of local switching rates would permit the LEC to engage in selective access charge reductions in order to respond to competition, while maintaining inflated local switching rates in other areas.

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80 Kwoka Affidavit at 21.

81 The lack of clarity as to whether and to what extent interexchange carriers can deaverage long distance rates makes this problem even worse. If an incumbent LEC can deaverage access but the long distance carrier must charge average rates, it may cause serious competitive problems for the long distance carrier.

2. Volume and Term Discounts

The Commission suggests that volume and term discounts for switched access elements may enable an incumbent LEC to reflect its actual costs more accurately. However, there is no evidence that there is a cost basis for volume discounts for access services other than transport. No studies have demonstrated substantial economies of scale associated with switching capacity. Likewise, it is highly unlikely that there is a cost basis for volume discounts for the CCL charge, whether assessed on a per-minute or per-line basis. Accordingly, lifting the restrictions on volume discounts for these services would not in any way permit the incumbent LEC to compete more effectively. Volume discounts would simply be a mechanism for the incumbent LEC to discriminate between different classes of access customers.

Similarly, term discounts represent a tool with which the LECs can lock in customers and prevent even efficient entrants from securing an adequate customer base.[82] "Potential competition" is not, as the Notice seems to suggest, sufficient to prevent the incumbent LEC from attempting to lock in customers before competitors have had the chance to establish themselves in the market. Indeed, the incumbent LEC has the greatest incentive to do so during the period of potential competition. This is especially true when the incumbent LEC can

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[82] Kwoka Affidavit at 22.

influence, through the provision of unbundled elements, how and when a "potential competitor" can enter the market.

The proposal to permit term discounts under conditions of potential competition is not consistent with Commission precedent. In the Switched Access Expanded Interconnection Order, the Commission permitted term discounts for transport services only when competitors had taken 100 cross-connects in the incumbent LEC's zone 1 offices. As the Commission noted, satisfaction of this condition provided "marketplace evidence that the LECs' expanded interconnection tariffs provide a viable competitive opportunity."[83] The Commission has provided no rationale in the Notice for now proposing to permit term discounts with absolutely no "marketplace evidence" that the Phase I checklist is sufficient to allow competitive entry. The Commission should require that competitors have taken some reasonable minimum number of unbundled network elements before permitting term discounts. Further, the Commission should require a "fresh look" provision that would enable an IXC to terminate a term arrangement once some threshold number of unbundled elements had been taken at a particular end office.

3. Contract Tariffs

The Commission's proposal to permit incumbent LECs facing potential competition to offer contract tariffs is completely without justification. The

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83 Switched Transport Expanded Interconnection Order, 8 FCC Rcd at 7435.

Commission suggests that the availability of contract carriage should lead to lower prices for those customers using contract tariffs. However, a significantly greater level of competitive entry is necessary to prevent the use of contract tariffs strictly for entry deterring and predatory purposes.[84] Contract carriage provides the incumbent LEC with unfettered pricing flexibility, giving it the opportunity to disrupt competition in the access market.

The Commission's proposal to grant contract tariff authority to incumbent LECs as soon as they have met the "potential competition" checklist is contrary to Commission precedent. As the Commission pointed out in its November 29, 1995 Order rejecting SWBT's attempt to afford itself increased pricing flexibility through the issuance of a Request For Proposal section of its FCC tariff,[85] even in cases where the Commission allowed AT&T to offer some of its long-distance services pursuant to contract carriage rates, the Commission has determined that "AT&T...may include in its contracts only those services the Commission has found to be substantially competitive."[86](emphasis added) Under the substantial

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[84] Kwoka Affidavit at 23.

[85] In the Matter of Southwestern Bell Telephone Company Tariff FCC No 73, CC Docket No. 95-140, Transmittal Nos. 2433 and 2449, 11 FCC Rcd 1215 (1995).

[86] See, Expanded Interconnection with Local Telephone Company Facilities, CC Docket No. 91-141, Transport Phase II, 9 FCC Rcd 2718, 2731, n 174 (1994). The Commission has not yet found that there exists sufficient competition for DS3 service, or in the interstate access market, to allow any dominant LEC to offer contract tariffs for such offerings. Id, see also, Local Exchange Carriers' Individual Case Basis DS-3 Service Offerings,

competition test, the potential for strategic pricing is reduced because a competitor has invested substantial sunk costs.[87] Only a year ago, the Commission proposed to apply the "substantial competition" test to incumbent LECs as well.[88]

Now, with little or no explanation, the Commission proposes to abandon the "substantial competition" test and require only "potential competition." The Commission's suggestion, that certain interconnection arrangements negotiated under Section 252 may be substitutable for access services, and thus place greater pressure on prices for incumbent LEC access services at an earlier phase in the development of competition than existed for AT&T, is without foundation. Pursuant to the Local Competition Order, Section 252 interconnection arrangements are only to be used for transport and termination, not access.[89]

Even if an incumbent LEC met the substantial competition test, however, it should not be permitted to offer contract tariffs. Contract tariffs provide a

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Memorandum Opinion and Order, 4 FCC Rcd at 8644 (1989). The Commission's treatment of AT&T's requests for pricing flexibility are discussed more fully in section VI(D)(1), infra.

87 Id.

88 In the Matter of Price Cap Performance Review for Local Exchange Carriers; Treatment of Operator Services Under Price Cap Regulation; Revisions to Price Cap Rules for AT&T, CC Docket No. 94-1; CC Docket No. 93-124; CC Docket No. 93-197, 11 FCC Rcd 925 (1995) (Price Cap Performance Review Second Further Notice).

89 Local Competition Order at para. 1033.

mechanism for the incumbent LECs to discriminate in favor of their own interLATA affiliates. The requirement that a tariff must be "generally available to similarly situated customers under substantially similar circumstances" is insufficient. It ignores the fact that tariffs are easily constructed so that only one user is positioned to adopt them, even if ostensibly offered to all.[90] At a minimum, the diversity of contracts and contract terms would make it impossible for the Commission to enforce the nondiscrimination requirements of Section 272(e)(3).

4. New Services Deregulation

The Commission proposes to deregulate new services for which a core offering would still be available, suggesting that this could create incentives for incumbent LECs to introduce services using new technologies. However, it is unclear how this pricing flexibility would help drive rates for core services to cost. In fact, the continued provision of "core" services in no way prevents strategic manipulation of price cap provisions to the disadvantage of customers.[91] As noted in the AT&T Price Cap Order,[92] the price capped firm can offer a scarcely different "new" service outside the cap at a price that attracts most customers

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[90] Kwoka Affidavit at 23.

[91] Kwoka Affidavit at 24.

[92] In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, Report and Order and Second Further Notice of Proposed Rulemaking, 4 FCC Rcd. 2873 (AT&T Price Cap Order).

from the original capped service. This results in a very low demand weight on the latter, so that its price may thereafter be increased without much adverse effect on other capped prices. That, in turn, allows the price of the unregulated service outside the cap to increase to near-monopoly levels.

The Commission should not consider deregulating new services until there has been several years experience with LEC provision of interexchange services. As with contract tariffs, the deregulation of new service offerings would create the opportunity for an incumbent LEC to tailor access offerings for its interLATA affiliate. Enforcement of the Section 272(e)(3) requirement that a BOC charge its long distance affiliate an amount that is no less than the amount charged to unaffiliated interexchange carriers would be almost impossible and would do nothing to guard against the anti-competitive effects of tailoring services to meet the specific needs of the incumbent LEC's affiliate.

D. Deregulation of Incumbent LEC Access Services

It is premature for the Commission to consider removing incumbent LEC access services from price cap and tariff regulation. The basic legal framework for local competition, established by the 1996 Act, has existed for less than a year, and many steps remain to be taken before the local competition provisions of the 1996 Act are fully implemented. Even in the narrow market for transport services, where the Commission's expanded interconnection rules have been in place since 1993, the LECs' physical and virtual collocation tariffs remain under investigation. By contrast, when the Commission initiated its inquiry into the state of competition in the interexchange market in 1990, the rules governing long distance competition had been in place for several years and tested fully. In particular, as the Commission discussed in the Interexchange Notice, the BOCs had been subject to equal access requirements for six years, and over 95 percent of BOC lines had been converted to equal access.[93]

In addition, by 1990 there was clear evidence that the rules governing interexchange competition were sufficient to encourage competitive entry. In the Interexchange Notice, the Commission noted that there were over three hundred competitors offering competing interexchange service, and that two of these carriers competed with AT&T in every state.[94] These competitors also offered virtually every service that AT&T offered.[95] By contrast, the incumbent LECs' only actual competitors are the Competitive Access Providers (CAPs), which provide only high capacity services to a limited number of customers in a limited number of buildings in the largest cities.[96]

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93 In the Matter of Competition in the Interstate Interexchange Marketplace, Notice of Proposed Rulemaking, 5 FCC Rcd 2627, 2632 (Interexchange Notice).

94 Interexchange Notice, 5 FCC Rcd at 2633.

95 Id.

96 The CAPs' market share of less than 0.5 percent only serves to demonstrate the immaturity of the competitive framework governing the exchange access market.

Finally, at the time that the Commission released the Interexchange Notice, there was clear evidence that new entrants were competing successfully. In the Interexchange Notice, the Commission cited AT&T's market share, which had declined substantially during the preceding five years, from 84.2 percent of switched interstate access minutes to 64.4 percent.[97] With respect to exchange access service, there is no clear evidence that the existing rules or industry structure allow for successful entry in the market.

Thus, measured by the standards of the Interexchange Notice, it is premature for the Commission to begin examining whether competition in certain exchange access markets is "substantial." Moreover, the Commission must preserve price cap and tariff regulation for the foreseeable future in order to safeguard competition in the interexchange market. As the Commission has noted, "[b]ecause interstate access services are a critical input in the provision of interstate interexchange service, [the Commission] also define[s] competitive harm to include LEC actions that could affect adversely competition in the interexchange market."[98] Because continued market power would allow the incumbent LEC to discriminate in favor of its own long distance affiliate, stringent standards would have to be met before the Commission could consider removing an incumbent LEC access service from price cap or tariff regulation. In

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97 Interexchange Notice, 5 FCC Rcd at 2632.

98 Price Cap Performance Review Second Further Notice, 11 FCC Rcd 858, 873.

particular, the Commission should preserve these regulatory tools until there has been considerable experience with BOC provision of in-region interLATA services.

1. Application of the AT&T Framework

The Commission seeks comment on whether the analytical framework that was used to streamline AT&T's services should be applied to incumbent LEC access services. In particular, the Commission seeks comment on which of the factors that it used in examining AT&T's pricing behavior could be used to determine when to remove incumbent LEC access services from price cap regulation. It cites demand elasticity, supply elasticity, market share, and the pricing of services under price cap regulation as relevant factors.

As noted above, it is premature to establish the criteria for evaluating the competition faced by incumbent LECs. The Commission need not and should not reach a decision regarding these criteria at this time. No one can predict how the access market will evolve, or even if competition will ultimately be successful. The Commission should not limit its options by deciding this issue today. Moreover, there are at least two reasons why the AT&T criteria should not be applied to the incumbent LECs. First, the economic model of a dominant firm -- presumably that used as a framework for developing criteria for competition -- does not contemplate a multiproduct dominant firm that is both supplier to and competitor of the same other firms. Second, the economic costs of premature deregulation are far greater in the case of the incumbent LECs than for a company without bottleneck control of any service.[99]

To the extent that the Commission applies a supply elasticity test to evaluations of incumbent LEC requests for regulatory flexibility, the Commission should find that substantial supply elasticity exists only when there is facilities-based competition.[100] In the Interexchange Order, the Commission's finding that AT&T faced substantial competition rested in large part on the existence of national facilities-based competitors, and the further demonstration that these competitors stood ready to accept considerable additional traffic in the relatively short term.[101] Because a purchaser of unbundled elements remains dependent on the incumbent LEC, and the ability of new entrants to use unbundled elements remains untested, the Commission should not adopt its tentative conclusion that the ready availability of unbundled elements indicates a high elasticity of supply. The Commission should also reject the incumbent LECs' assertion that the fact that they have relatively few access customers makes the interstate access market highly demand responsive. This view fails to recognize that the IXC controls only the selection of transport services, while the rates for

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99 Kwoka Affidavit at 19.

100 In product markets where inputs are not controlled by a downstream entity, supply elasticity will increase with an increase in the supply of inputs. But here, the legal availability does not translate into market availability.

101 Interexchange Order, 6 FCC Rcd at 5889.